

I. Introduction

AllEnergy Marketing Company, L.L.C., Alternate Power Source, Inc., EnergyEXPRESS, Enron Energy Services, Exelon Energy, GreenMountain.com, National Energy Choice, New Energy Ventures, The Northeast Energy Efficiency Council, Sun Power Electric and Utility.com, (collectively, the Retail Market Participants) submit the following comments in response to the Order Commencing Notice of Inquiry and Seeking Comments, D.T.E. 99-60 ("NOI"), issued by the Department of Telecommunications and Energy (the "Department") on June 21, 1999. In its Order, the Department initiated a notice of inquiry ("NOI") proceeding regarding the pricing and procurement of default service.

The preceding presentation is now an opportunity to implement a Default Service which will support the development of a retail marketplace that will bring the benefits of competition to all customers and that will be fair to all customers and suppliers. As market participants committed to the development of competitive wholesale and retail markets, we propose in these Comments an approach to assure that the Default procurement process and prices reflect the full costs of serving retail customers and therefore provide the correct price signals. To explain the critical importance of this accurate price signal for Default Service at the retail level, we also outline the ways in which the price and other benefits of competition can only be obtained with full and fair retail competition and cannot be obtained by utility-managed competitive bidding in the wholesale market.

Once a market-based policy and generation pricing mechanism has been designed for Default Service, any rate design issues that arise in implementing the new default generation pricing can be resolved. We recognize the concern about potential rate increases or disparities for customers who fall onto Default Service, relative to the below-market Standard Offer prices, and we are confident that rate measures can be designed to prevent or minimize any such inequities without constraining the design of the generation pricing mechanism for Default Service or continuing to prevent genuine competition.

We have not attempted in these Comments to recommend a detailed prescription for the "end-state" for default service. As retail markets begin to develop in Massachusetts, the Department may identify from time to time ways in which Default Service, or other elements of the regulatory structure, could be further "tuned" to allow and encourage the full and fair competition which will provide the greatest price reductions to consumers. Such ongoing monitoring of the progress of retail market development will identify the extent to which the Default Service resulting from this proceeding is achieving the goals of restructuring. If changes need to be made in order to allow the market to work, the Department can base such decisions on the information available at that time.

The Massachusetts market structure as implemented to date, reflects an inconsistency between the mandated utility price offerings and the development of retail markets. In order to achieve a successful transition to a competitive market that can bring the desired benefit to all consumers, it is critical that Default Service be correctly identified as other than a wholesale service. In fact, it is a retail service to customers, required by statute to

be facilitated by the utility. Under this construct the generation commodity is sold to customers by a designated provider at an administratively determined price. Customers compare competitive offers to the standard offer price and default service price. Competitive retail suppliers such as those submitting these Initial Comments compete directly with Default Service prices (as they do with standard offer prices and with other retail price offers to their potential customers), and therefore compete with the Default Service provider. It is imperative that the procurement process and prices of default service be designed to reflect the benefits and costs that are experienced by its suppliers and other suppliers to retail customers. Only then will it reflect the proper price signals to consumers and the market. Default service should not be subsidized by other services or other customers by including less than the full cost of service.

1. Statutory Requirements

The key issue in this proceeding is whether default service is a) a protected, subsidized service that guarantees a price that is below what the market can provide; or b) simply a guarantee of access to power temporarily at no more than the average price that retail customers with similar load characteristics pay in the market. A review of the Massachusetts Electric Restructuring Act makes it clear that default service is the latter – a temporary access guarantee, not the former – a below the market price guarantee.

Chapter 164, section 193(1B)(d) of the restructuring act provides in pertinent part that

...each distribution company shall provide its customers with default service and shall offer a default service rate to its customers who have chosen retail electricity service from a non-utility affiliated generation company or the supplier to provide contracted service or who, for any reason, have stopped receiving such service, and to all customers at the end of the term of the standard offer. The Distribution Company shall procure such service through competitive bidding; provided, however, that the default service rate so procured shall not exceed *the average monthly market price of electricity.*" (emphasis added).

This language tells us three important aspects of default service. First, default service must be competitively procured. Second, the only cap on default service rates is the "average monthly market price of electricity." Finally, default service is a "bridge" or "backstop" transition service. No where does the language of the statute provide that default service should be provided to customers on a long-term basis or at a rate that is below cost, with the resulting shortfall being deferred and/or collected from other customers. However, that is exactly what is happening today.

A comparison with standard offer service is very instructive. The legislature has made a very clear delineation between the two services. Standard offer is about price protection. The legislation creates two separate price protection provisions for standard offer. First,

subsection (b) of section 1B mandates discounts for standard offer customers of first 10% and then 15% of historic rates. Second, subsection (e) creates an overall inflation cap for standard offer customers. Significantly, neither of these price protections applies to Default Service. They both apply only to standard offer service. The only protection for default service prices is the language in subsection (d) providing that the default service price should not exceed the average monthly market price. In addition, the legislature clearly established a multi-year period for the standard offer service, while the only time periods mentioned in connection with default service pricing are one month and six months, consistent with its role as a "backstop" while the customer is temporarily without a Competitive Supplier.

The legislature's decision to apply price protection provisions to Standard Offer and not Default Service dictates that the two services are very different. Standard offer is about guaranteeing low prices to existing customers during a transition period where the Distribution Company is exiting the generation business, regardless of what the market can provide. By contrast, default service is about guaranteeing access to power on a short-term basis at no more than the average price that the market can offer. Default service should be priced accordingly. To set the default service rate at the standard offer rate is to ignore the language and the intent of the statute.

III. Relationship between Wholesale and Retail Competition

Vibrant retail electricity markets contribute to competitive wholesale markets in several ways. First, they contribute to dynamic efficiency by increasing the level of information conveyed to consumers about the price signals originated in wholesale markets. Second, competitive retail markets reduce the potential for *de facto* vertical control, weakening the ability of wholesale players to pass price increases through to final consumers. Third, the existence of multiple credible players in the retail market contributes to the ability of new entrants to generation markets to obtain contracts for their output, thus improving the ability of new entrants to attract financing and therefore complete their projects. Lack of true retail competition means that wholesale prices provide inaccurate signals to wholesale market participants regarding the need for new capital investments, desired technologies, and optimum project size, leading to higher final prices to customers.

P. Chrisman Iribe, Chairman of the Electric Power Supply Association and U.S. Generating Company, recently described the inextricable relationship between wholesale and retail competition:

Wholesale competition is the engine that provides the largest share of cost reductions, efficiencies gained and risks managed for consumers. Retail competition is the engine that drives wholesale competition, product and service innovation...Competitive wholesale markets need depth, liquidity, lots of products and transactions, lots of buyers and sellers, and lots of price visibility. Where does this much depth and liquidity come from? The new wholesale customers, products and transactions that are created by retail competition.

In other words, we will not get all the benefits of wholesale competition unless we have effective retail competition. One can think of no competitive industry that does not have retail competition.

IV. Benefits of Retail Competition

Vibrant retail competition brings benefits of its own; over and above the benefits that it brings by enabling more effective wholesale competition. As the President's Council of Economic Advisors noted in its 1997 Report to the President:

That deregulation produces economic benefits when it leads to effective competition is not merely a theoretical proposition. Data from the field bear this assertion out as well ... [D]eregulation not only has brought significant short run benefits, by making markets work better, but also has lead to technical and operating innovations that promise even greater benefits in the long run.

The 1997 Act reflects the Legislature's belief that Massachusetts's retail electric customers will benefit from competition because competition will lower rates over the long run, introduce innovation and improved service. Prices will be lowered as competition introduces efficiencies into every retail function in the power business, including back-office functions, metering, billing, customer service, etc. (not just efficiencies in the generation functions). In the competitive retail market, there may be some "new" costs associated with competing for customers (e.g., advertising), but "full and fair" retail competition will minimize these new costs as well as offsetting them by new efficiencies in the back-office and customer service functions. For example, competing retailers will minimize advertising and other retail costs by seeking to serve aggregated buying groups, by using the Internet and by bundling multiple energy and other products.

Within network industries the various benefits of competition through deregulation have been well documented. In a 1997 study entitled *Economic Deregulation and Customer Choice: Lessons for the Electric Industry*, Robert Crandall and Jerry Ellig reviewed numerous economic studies on the benefits of competition in five network industries that have experienced deregulation: natural gas, telecommunications, airlines, trucking, and railroads. Crandall and Ellig conclude as follows:

...regulatory reform is not a zero sum game; it has generated genuine gains for consumers and society as a whole. Consumers gained for two reasons. First, deregulation or regulatory reform aligned prices more closely with costs, leading to a more efficient use of resources by both firms and customers. Second, firms faced greater incentives to adopt cost-reducing or quality-enhancing innovations in technology, marketing, and business strategy, which often were not predicted beforehand."

From a consumer perspective, the benefits of competition can be summarized into three general categories: innovation and technological progress, service improvements, and price reductions from improved efficiency.

From experience in other competitive industries, it is clear that competition spurs innovation and technological progress. The telecommunications market introduced call waiting, call forwarding, caller ID, cell phones, messaging and numerous other technologies and services subsequent to the deregulation of the telecommunications industry. As electric markets begin to open, competitive suppliers are innovating through products and services such as higher efficiency generation assets that are environmentally friendlier than older plants, distributed resources located at customer sites, improved price risk management software, improved metering technologies and improved call center technologies. As more jurisdictions open and competition intensifies, more innovation will undoubtedly occur.

Retail competition has also clearly led to service improvements. Crandall and Ellig note

"Just five years after trucking deregulation in 1980, shippers saved almost \$1 billion annually in reduced costs due to more rapid service. Railroad delivery time improved by nearly 30 percent in the five years following railroad deregulation. Almost half of the consumer benefits due to airline deregulation stemmed from the value of increased flight frequency."

Competition also drives business to be more efficient which leads to reductions in price. Evidence from previously deregulated markets clearly shows decreases in prices paid by consumers. The 1997 Report by the Council of Economic Advisors found that the introduction of competition in airlines, trucking, railroads and natural gas industries produced significant efficiencies and cost savings. Likewise, in a study by Crandall and Ellig, savings were at least 5 percent in the early years and have approached 60 percent 10 years after deregulation. A summary of the price reductions is shown below.

Consumer Price Reductions Due to Deregulation

Industry	2 years	5 years	10 years
Gas	10-38%	23-45%	27-57%
Long Distance	5-16%	23-41%	40-47%
Airlines	13%	12%	29%
Trucking	--	3-17%	28-56%
Railroads	4%	20%	44%

--" not available

Studies conducted in the electric industry predict similar savings will occur. The Department of Energy's Energy Information Administration forecasts price declines of 12 to 19% in a model that includes restructuring efforts of only a few states. In a 1997 study by Clemson University economists, electricity price reductions from deregulation were even larger. "We estimate that, in the short run, competition will cause price to fall by at least .9 cents per kilowatt hour on average across all classes of consumers in the United States. The long run price decline of electricity could reduce residential consumer bills by as much as \$30 per month. Based on the current \$69 per month bill, the decline is substantial, at least 43 percent."

Experiences in Pennsylvania and California have proven that customers are interested in many of the product and service innovations listed above. For example, many customers are purchasing clean or green power products – over a third of choosing customers in Pennsylvania are. (For more information on experience in other states, see Appendix B.) In Pennsylvania, where shopping credits in two utilities' areas more closely reflect the true cost of delivering generation, customers have seen savings of up to 40%. Whereas, in California, where the default rate is equal to the wholesale price, customers are experiencing overall savings of only 1-10%, residential customers up to 5%.

It is beyond debate that competition brings benefits through cost reductions and innovation. It is possible that we would realize some of these benefits through a competitive wholesale electric market alone, though researchers have found that electricity generators can exercise market power and increase wholesale prices when customers lack retail choices. However, there is also no doubt that we would realize all the benefits if we also had a competitive retail electric market. The Department's decision regarding default service will do a great deal to determine whether that market ever develops in Massachusetts. The intent behind the establishment of the Default Service mechanism was to assure that, as we introduce competition to achieve the benefits outlined above, we also avoid creating disruption for consumers in their basic electric service during this transition. It is possible to meet the customer for which default services was intended and to maintain a fair distribution of the benefits of restructuring while allowing the retail market to develop in an expeditious and orderly manner.

V. Role of Default Service Pricing in the Development of the Retail Market

As is described in the Law, Default Service is a fallback access mechanism to protect certain consumers in the retail market, namely those who are temporarily without a Competitive Supplier for whatever reason. (Chapter 164, Section 193, Section 1b(d)). A poorly designed Default Service will result in a large number of customers using it in perpetuity rather than taking advantage of the innovative product and service offerings in the competitive retail market. Decisions on how that large block of Default Service load is priced will effect retail developments such as the number of suppliers in the market, retail prices, and product offerings. Default service is a necessary, but artificial construct,

which exists only on a very limited basis in other, more mature competitive markets. Therefore great care must be given to its design and pricing.

The design of Default Service will play a critical role in the implementation of a competitive electricity market in Massachusetts for five reasons. First, a significant percentage of the retail market currently receives Default Service (estimated at 10%). Unless the pricing is market-based, this number will only increase over time as customers relocate and as new construction comes on line. The only way to avoid this increase in the number of default customers is to price the service at full cost and in a way that competes *fairly* with potential retail suppliers. Experience has shown that customers are hesitant to migrate to a competitive supplier during the initial phases of competition, especially if they are given a semi-regulated, subsidized, below-market default option. Massachusetts's experience is a good example of such market behavior, where 16 months after the market opened, nearly all existing customers have remained on Standard Offer. Second, during the initial periods of market development, the Default price is the "price—to--compare" against which these customers evaluate offerings from competitive suppliers. This would represent a particular problem if the Default price calculation yields a price level which does not reflect all relevant costs and is therefore well below competitive retail price offers. Third, if the number of Default Service customers is many and its related load large, its procurement could result in market power concentration and higher prices at the wholesale level.

Fourth, if Default Service is offered to customers on an open-ended basis with no time limit, then many or most customers will naturally tend to stay on it rather than shopping for a Competitive Supplier, and the transition to a competitive market will be anything but "expeditious," and will not even be "orderly." Rather, Default Service will become a public policy to limit the benefits of retail competition. Since this is clearly not the intention of the legislation, the Department should develop a process under which, as soon as a sufficient number of Competitive Suppliers have established an effective business presence in Massachusetts or New England, a limit will be set on the time period for which default service will be made available to any particular customer. For example, when a customer is placed on Default Service in the middle of a billing period, the service could be provided for the remainder of that billing period, after which time the customer would be assigned to a qualified Competitive Supplier through a process carefully designed to be consumer-friendly. It is time to establish this policy now, so that customer expectations of Default Service will be realistic, and suppliers will have a basis for assessing the future size of the Massachusetts market, and a sound process can be developed before it is needed. Fifth, to the extent that the continued availability of a poorly-designed Default Service limits the development of the retail market, it will not only harm the customers who remain on it, but will also reduce the innovation and limit the reductions available to customers who do look for competing products.

VI. Description of Default Service

A. Components of Default Service

The Massachusetts Restructuring Act provides that default service prices should be no higher than the "average monthly market price." Since there are no discoverable retail market prices in this undeveloped market upon which to base a default service price, a cost-based proxy must be used.

The proxy market price must include **all** of the costs of providing electric service to retail customers. If it doesn't, two things happen. First, the default service price is subsidized, which sends an incorrect price signal to customers and thwarts the development of a competitive retail market. Second, those customers who switch to a competitive supplier end up paying some of the costs twice: once to the utility which is no longer providing the service and once to the competitive power supplier which is providing the service.

We have divided the costs of providing retail electric service into two primary components: 1) commodity costs; and 2) administrative and customer service costs. Those cost components are described below.

1. Commodity

In order to create a viable retail electric market, the price of Default Service must reflect the costs of serving retail customers and therefore provide the correct price signals. Accordingly, the price must reflect fully allocated commodity costs associated with serving retail load. The design of a pricing methodology for default service should be guided by the characteristics of that service and the characteristics of the various resources used to provide it. Key characteristics include the fact that:

- the level of default service required varies from hour to hour, month to month and potentially by location;
- the market price of electric energy and related capacity and ancillary services varies from hour to hour and potentially by location;
- the resources used to provide default service include both contractual and spot purchases, and is frequently purchased and scheduled in advance based on estimates of those requirements;
- the actual level of default service requirements for a given location in any time period fluctuates and will almost always be different from the estimated level;
- default service carries a higher risk premium than standard offer service; and
- commodity costs vary by customer class because average load shapes and load factors vary by customer class.

In order to create a viable retail electric market, the price of Default Service must be designed to recognize all endogenous and exogenous costs associated with providing the service and all inherent value associated with the distribution company franchise; i.e., it must support the principle of comparability of service and every attempt must be made to assign value to each component in the value chain of providing retail service. These include the following categories of costs:

- wholesale commodity costs (to the extent these continue to be required by ISO New England at the wholesale level), including energy (and associated transmission losses), operating reserves, AGC, Operable Capability, Installed Capability, ISO uplift and administrative charges associated with spot market purchases of these commodities;
- transmission charges (service charges, congestion charges, and ancillary service charges not included in commodity costs above);
- scheduling and control area services;
- distribution system losses;
- share of ISO-NE operating expenses;
- risk management premiums;
- load shape costs;
- commodity acquisition and portfolio management;
- working capital;
- taxes; and
- administration and customer services.

Each of these costs is described in detail below and a hypothetical example is included in Exhibit A. Depending on what the Default provider requirements are, certain of these costs may be incurred by the Default provider while others may be incurred by the distribution utility. Regardless of which party incurs which costs, they all should be recovered in the price of Default Service; otherwise customers on the service will not see its true cost and competitive retail suppliers will be at an unfair disadvantage in competing for those customers.

a. ISO-NE Requirement Costs – Energy, Capacity & Ancillary Services

Load Serving Entities (LSEs) in New England are responsible for acquiring seven products: energy to meet their load (and associated transmission losses); installed capability: operable capability, ten minute spinning reserve; ten minute non-spinning reserve; thirty-minute operating reserve; and automatic generation control. The LSE may choose to acquire these products bilaterally or on the centralized spot market coordinated by ISO New England.

b. Transmission costs

LSEs incur transmission costs associated with the delivery of energy, which they can recover from all their customers. Because transmission costs can differ depending on the location of the resources used by the LSE to meet its various needs and on the location of the load served, transmission costs that are specifically related to its provision of default service should be separately accounted for (if not fully reflected in provider bids) and allocated to default service customers. Currently, wholesale transmission service charges and losses may differ depending on whether the source of energy is inside or outside the NEPOOL control area. In the future, transmission congestion charges may differ depending on the exact locations of the energy resource and the load.

c. Energy imbalance costs

At the retail level, an energy imbalance is the difference between energy scheduled by a retail supplier based on a forecast of customer usage and the energy actually consumed or metered by the supplier's customers. Imbalances at both the wholesale and retail levels are inevitable because customers' usage fluctuates day-to-day, hour-to-hour, and moment-to-moment. It is highly unlikely that any energy provider, including the Default Service provider, will predict to 100% accuracy the actual amount of energy used by its customers. The costs associated with additional energy purchases or sales necessary to balance the utility energy supply with customers' needs should be included in the default price.

d. Distribution system Line Losses/Related costs

Line losses for retail customers average between seven and ten percent depending on the voltage level at which the customer is served. Line losses have a financial value associated with them that must be included in the Default price.

e. Load shaping/Load Following Premiums

Wholesale power is typically sold via contracts for a constant rate of delivery (for example, contracts for supply at 24 hours for seven days). Retail customer demand is variable. Therefore, the delivery pattern of wholesale products will not match customer loads. The hourly variations, up and down, are referred to as shaping energy. The Default customer price must reflect the value of the shaping service performed by the Default provider.

f. Risk Management Premiums

There is a premium associated with the risk of serving any competitive market. Default service from any provider, whether it is a distribution company, a wholesale supplier or a retail supplier reflects the cost of this premium. This cost should be incorporated into the default price.

In addition to financial risk, there are risks associated with volume and price. Depending on how the default service contract terms are designed, the default service provider's volume and price risk management may be imbedded in the Default provider's service.

Default service is for new accounts that have not selected a supplier, or for customers returning from supplier service. Customers may leave at any time. By its very nature, the volume of default service may be highly volatile, and will certainly change over time. There is a very limited track record on how default service load will vary over the course of service, therefore, it will be difficult for a Default provider to accurately forecast load and purchase power in quantities that closely reflect these changes. The risk is compounded if the Department were to determine that the default customer would be started out on the 6-month "uniform price", rather than on the "average monthly" retail

price. Spot market prices will change hourly. By offering customers a fixed price, whether it is for one month or six months, default providers are insulating the customer from price variability and incurring the risk themselves. This risk management has a cost which should be included in the default service price.

g. Commodity acquisition and supply portfolio management costs

When the distribution company procures default by buying at spot market or issuing periodic RFPs, it has activities and costs relating to managing and obtaining the commodity supply. These include personnel and related costs necessary for evaluating bids and negotiating and executing contracts. Likewise, the Default Provider faces the same personnel and management costs from negotiating contracts as well as monitoring price movements and trading power. These are legitimate and real activities with costs related to providing default supply service and should be included in the default service price.

h. Taxes

Applicable taxes on the energy and related services will be charged to all providers of retail commodity. These taxes may be collected by the distribution utility for the default service provider. The administrative cost of collecting these taxes should be included in the default service price.

i. Working Capital

Working capital is the cost of financing cash flow (interest costs). The timing of the streams of cost outflow and revenue inflow don't coincide, and the default service provider or the utility must finance cash flow imbalances. This also includes the cost of financing levelized billing plans offered to retail customers. These costs must be included in the calculation of the default service price.

2. Administrative and Customer Services

In addition to the commodity costs described above, there are various administrative and customer services costs involved in providing electric service to retail customers. These costs are described below.

a. Credit, collections and bad debt

All competitive suppliers have costs associated with credit, collections, and bad debt. Utilities also have such costs, associated with both the generation cost component of default service and the T&D components of the rate. Under current ratemaking, however, utilities' generation-related credit, collections, and bad debt costs are not collected through the

generation price but rather through other parts of the rate structure. An allocation of these costs should be included in the default service price.

b. General overheads

All competitive suppliers have general overheads, including office space, legal, accounting, information technology, executive salaries, etc. Utilities also have these costs, and a percentage should be allocated to default service.

c. Customer call centers

All competitive suppliers have call centers and other mechanisms for communicating with customers and answering generation-related questions. Utilities also have these costs, some percentage of which are attributable to the generation component of default service and should be included in the default price.

d. Customer enrollment costs

All competitive suppliers have costs associated with enrolling customers. There are similar costs associated with enrolling default service customers. These costs should be included in the default service rate.

e. Customer acquisition

All competitive suppliers have customer acquisition costs. This is one type of cost that is not shared by utilities; as monopoly providers, electric utilities do not have customer acquisition costs. However, these costs cannot be ignored if Massachusetts is to have a competitive retail electric market.

f. Information Exchange

Suppliers in Massachusetts bear all costs of data exchange which is currently transacted over value added networks. A proxy for these costs should be included in a default service price.

A. Ratemaking

Many of the retail functions described above will be part of the competitive bid to provide default service power. For example, the cost of energy and related commodity costs will almost certainly be part of the bid. Thus, basing the default service price to customers on the utilities' cost for default service power would capture many of the necessary costs (as long as the utility's cost is set through a competitive procurement).

According to a recent filing by Massachusetts Electric, this step alone would increase the price of default service by 6 mils.

However, there are other retail functions that will likely not be included in the bid to provide default service power, and which will necessarily be performed by the distribution company. The cost to perform these services should be included in the default service price.

To avoid double collection of the costs of services provided by the utility in distribution rates and again in the default service rate, the revenue collected for these services by the utility from default service can be credited to all customers through either a credit to stranded costs or by a separate distribution rate crediting mechanism such as the Local Distribution Adjustment Charge, "LDAC", that exists in Massachusetts natural gas distribution rates.

Some states also vary the default service rate by rate class or broad categories of load shapes. This allows the price to more accurately reflect the cost of service and provides the default provider with more certainty that it will be able to recover its costs. Additionally, it more accurately reflects the way the retail market prices service to customers.

C. Terms and Conditions

In addition to comparing the price of default service to that of competitive offerings, customers will also compare the terms and conditions. In order to promote a vibrant competitive market, it is essential that the default service terms and conditions be as basic as possible, and not include any of the value-added guarantees and services that competitors will offer. A number of key provisions are discussed below:

a. Price Stability

Competitive suppliers offer fixed-price contracts in order to protect customers against the price volatility of the wholesale markets. If Default Service offers similar price stability, it will interfere with the ability of the competitive firms to offer this protection as a value-added service. The restructuring act requires that Default Service include "Payment options with rates that remain uniform for periods of *up to* six months"(emphasis added) but six months should clearly be the maximum term available and this uniform option should only be provided if the customer specially requests it. In other words, any such uniform rate payment option should not be a "default" feature of the service. Also, if this payment option is essentially a budget billing arrangement, then customers should be clearly informed before they select such an option that they will owe the market (bid) price such that, while rates will remain uniform for 6 months, the customer will be at risk after the 6-month period to pay the market price if

it turned out to be higher than the uniform rate (otherwise the customer would receive a rebate.)

b. Green Power

Several competitive firms distinguish their product by offering "green power." Default Service should not compete with this product: it should be power that has standard environmental characteristics, including meeting any applicable portfolio requirements as discussed elsewhere in these comments.

c. On-line billing

Another service that many competitive firms offer is on-line billing. Default service should not compete. Default service should provide only standard, paper billing.

D. Selection of Default Service Provider

1. During the Transition to Competition

As discussed in Section II, above, the statute presently requires that distribution companies procure default service through competitive bidding. Requiring competitive bidding of default service does not, however, automatically eliminate the potentially anti-competitive impacts of this service. The bid process must be carefully designed to avoid creating a default service that acts as a barrier to customer opportunities in the competitive market. Three important elements in the design of the default service auction are described below.

Multiple Winners. As part of the transition to a fully competitive market, it is important to structure default service in a manner that does not simply replace one incumbent supplier with another. One way of doing this is to structure the default service auction so that there are multiple winners. Dividing default service into smaller blocks of customers creates opportunities for new, smaller market participants to serve default customers. In contrast, a "winner takes all" approach may simply transfer the advantages inherent in the incumbent position from the distribution company to the winning bidder. An example of an auction with multiple winners follows:

First, the Department establishes the terms and conditions of default service, including each of the components identified in section V.A, above, as appropriate. The Department also defines the requisite qualifications for default service providers. An auction process among qualified suppliers would be used to determine the price of default service. (For example, based on a blend of the lowest three bids). Auction participants would have the option to choose to serve at the winning price. Default service load would be allocated among the multiple suppliers who opt-in on a pro rata basis.

Frequent Auctions. Shorter contracts and more frequent auctions are likely to result in bid prices that more accurately reflect existing market prices at the time of service. We would suggest holding default service auctions on a six-month basis, with a variable monthly price as the normal or "default" option for customers, as a means of establishing default service prices that are reflective of actual market conditions.

Bids by Rate Class. The cost to provide power for retail customers varies by customer class. This is because the different customer classes have different average load shapes and different average load factors. Accordingly, the Department may want to consider separating default service bids for different customer classes as an additional mechanism for bringing default service prices in line with market conditions. For example, the Maine Commission has taken this approach, separating bids only for the broad customer categories (e.g., small, medium, and large) and not for each individual rate class. As noted elsewhere, once the generation pricing is market-based, other rates could be adjusted to minimize any transitional impacts on particular rate categories and to maintain fair distribution of the benefits of restructuring during the transition.

1. In a Fully Competitive Market

The competitive bidding process described above provides a reasonable means of identifying default service providers during the transition to a competitive market. Once a viable market has been established, however, there is no need for a stand-alone default service. Customers who find themselves without a supplier for any reason could simply be assigned to Department-approved competitive suppliers on a pro-rata basis. Once a customer has been assigned to a competitive supplier, that customer should be free to choose an alternative supplier. The customer fees associated with such a switch should be minimal, designed only to recover the administrative costs of making the switch, and should not apply to the switch represented by the assignment. As long as the legislative requirement for a default service remains in effect, the Department should develop a process under which a limit is set on the time period for which default service will be made available to any particular customer as discussed elsewhere in these comments.

E. Renewable Portfolio Standard Applicability

Any RPS requirement should be applied to each company providing retail service. A different approach would mean that some customers would pay the full cost of promoting public policy while others got a free ride. If a Default provider were to serve customers outside of Default Service, these customers, rather than all customers (including Standard Offer and Default Service customers) would have to bear the burden of meeting all of the providers' RPS requirements if applied to their entire company portfolio. In addition, exempting the Default Service provider from RPS requirements would result in a significant competitive disadvantage to retail suppliers competing for customers that receiving Default Service.

VIII Conclusion

Default service will be the critical benchmark by which customers no longer on the Standard Offer will compare various competitive suppliers' offers. It should reflect the cost of providing retail services, including default-related functions provided by the utility, and should eventually be transitioned into an assignment approach or mandatory selection for customers as the market develops.

Appendix A

*All*Energy Marketing Company, LLC is a wholly owned subsidiary of New England Electric Systems (NEES). *All*Energy provides natural gas, electricity, oil, propane, and value-added services to businesses and consumers in New England and the Northeast. It is the largest retail energy marketer in the Northeast and presently serves over 100,000 customers. *All*Energy was founded in 1996 in response to opportunities created by the restructuring of the energy industry.

Alternate Power Source, Inc. (APS), a pioneer in the power deregulation industry founded in May 1995, is a leading electric consultant and brokerage firm based in Westwood, Massachusetts. The Firm, comprised of utility specialists, including senior executives of power and fuel purchasing, rates, and power engineering, offers alternate sources of competitive energy to its growing list of clientele. APS provides a full package of consulting and marketing services to private and public companies in the United States that result in more competitive rates with power suppliers who offer the terms that best fit individual client's requirements. To date, APS has contracted to supply more than 3000 properties with electricity totaling 200 megawatts including customers such as John Hancock Mutual Life Insurance; Hines Interest Group; National Development; Chiofaro Companies; Citizens Bank; Big Y Foods, Inc.; Texas Instruments; and Fleet Bank.

EnergyEXPRESS, Inc. is a non-regulated energy marketing company located in Westborough, MA. EnergyEXPRESS offers comprehensive, customized solutions to satisfy the needs of a broad range of customers throughout New England. Product offerings include natural gas, propane, fuel oil and electricity.

Enron Corp. is one of the nation's leading electricity, natural gas and communications companies. The company, which owns approximately \$30 billion in energy and communications assets, produces electricity and natural gas, develops, constructs and operates energy and water facilities worldwide, delivers physical commodities and financial and risk management services to customers around the world, and is developing a nationwide Internet-based communications network.

Exelon Energy, a PECO Energy Enterprise, is a leading supplier of electricity and/or natural gas in Pennsylvania, Massachusetts, New Jersey, and Delaware. In Massachusetts, Exelon is best known for its partnership with HEFA and its PowerOptions program, providing electric supply to the non-profit community and saving it millions of dollars over the life of the contract. Nationally, Exelon offers services in Infrastructure Management, Energy Consulting, Communications and Energy Services.

Green Mountain Energy, a service of GreenMountain.com is a leader among U.S. energy marketing companies. We offer renewable energy to consumers who care about the environment. Green Mountain Energy is a licensed Energy Service Provider in California and a licensed Electric Generation Supplier in Pennsylvania. Green Mountain Energy is currently the only supplier residential customers in both of these states. Green Mountain has been active in regulatory proceedings throughout the U.S. and has testified before various state legislatures and regulatory commissions.

National Energy Choice is a program of NEChoice, LLC, an aggregation company headquartered in Boston with offices in Oakland, CA. National Energy Choice works solely on behalf of its customers and is not exclusively affiliated with any utility or power supplier. Led by industry experts Paul L. Barrett, Stephen J. Remen and Steven M. Rothstein, and CEO John Giesser, the company currently represents one of the largest pools of energy users in the country. National Energy Choice manages energy bills for a wide range of clients, such as theaters, hotels, municipalities, nursing homes, manufacturers and retail chains. For more information, please call 1-888-772-WATT or visit National Energy Choice's web site at www.NEChoice.com

New Energy Ventures, Inc. ("NEV" or "Company") is the leading national energy service provider of integrated energy solutions to its customers. The Company offers competitively priced retail electricity supply and information services, distributed generation, and other products and services including electricity portfolio management and scheduling, energy efficiency and management systems, and energy-related procurement services. The Company's state-of-the-art information technology systems provide customers with many new services including real-time energy usage and price information accessible through the Internet, automated billing and customer calling centers. These systems provide NEV with specific information on customer usage and provides the foundation for selling additional products and services to a large and growing customer base.

The Northeast Energy Efficiency Council is a business association of energy efficiency companies. Its member companies manufacture and sell energy efficient products and provide energy efficiency services. The Council has joined in these comments because it believes that the development of a competitive retail electric market will foster the development of a vibrant competitive market for energy efficiency products and services.

Sun Power Electric, a division of Conservation Services Group (CSG), develops, constructs, owns and operates renewable photovoltaic (PV) generation for supply as part of the new electricity products that consumers will be able to choose as retail competition is introduced across the country. Sun Power Electric's mission is to bring down the true costs of PV generation through the application of research and development to each aspect of grid connected systems, including installation techniques, inverter technology and operation and maintenance. Sun Power Electric meters, monitors, maintains and sells the PV generation to meet the needs of the retail market and to achieve the benefits of distributed generation. Sun Power now has PV facilities in MA, RI and PA.

Utility.com is a registered Energy Service Provider in California, and one of only two companies actively selling competitive electricity to residential and small business customers throughout that state. Utility.com is also the first company to file for a license to sell competitive power in Nevada. Utility.com plans to enter the market in Massachusetts as soon as regulatory and market conditions permit.

Appendix B

Responses to Specific Questions Posed by the Department

1. Is it appropriate at this time to change the way default service is priced (e.g. to separate the pricing of default service from the standard offer price)?

Yes, default prices should be allowed to diverge from Standard Offer prices, which are recognized to be artificially set at levels which are now significantly below-market. This will be necessary in order to avoid any further subsidies of the prices to default customers, and any further deferrals of costs that will have to be paid by future ratepayers. Neither the law, the Department rules to date, nor the settlements provide a basis for continuing to equate the prices of these different services. There is no basis in any of these guiding documents for a policy of preventing differences between prices paid by customers with and without eligibility for Standard Offer. This is a particular concern while Standard Offer is below market, since legislation indicates a form of market pricing for default. The importance of establishing default service as a market-priced service is discussed below and in Section V.

It should be noted that, while a market-priced default service might be more expensive than the standard offer service in the early years, this would be offset to the extent that market prices for default service fall below the Standard Offer price in the last few years of the Standard Offer period.

There is no reason to wait for further market developments before establishing market pricing for default service. At the retail level, the lack of retail competition is an argument for market pricing, and a retail market price or index can be developed even before robust competition has begun. At the wholesale level, the ISO spot markets have begun to function, and while there may be uncertainty about prices for this summer, there is no reason not to implement market pricing this fall.

2. What should be the basis for the "average monthly market price of electricity"?

Wholesale prices are not an appropriate basis for default service, and there is no basis for pricing this service at a wholesale level in the law or regulations to date. Rather, the price paid by the default service customer should be what the law refers to as the "average monthly market price of electricity." See our proposed definition of this term in Section VI. Until retail competition has reached a level of competitiveness such that it allows a transition to an assignment or other method of providing default services at a market price, it will be necessary to determine the monthly price through the use of competitive bidding, as suggested in the law, and through measurement or estimation of the other costs of providing generation service to default customers. Our proposal to accomplish this is presented in Section VI.

3. If the default service rate should reflect retail prices, how should the rate be determined?

Please see Section VI.

4. Does the use of retail market data require that the cost of retail services to default customers be moved from the distribution component of customers' bills to the generation component of customers' bills? If so, how would that best be accomplished?

Yes. Please see Section VI.

5. How should the price be determined? For example, should the price be based on historic market prices or on projected market prices, or should it vary with the actual market price over the course of a month?

Default Service prices should vary with the level of actual market prices to retail customers. To the extent possible, pricing should not be fixed in advance by regulators; rather, prices should vary as frequently as possible to reflect changes in market conditions. That is, it should be understood in advance and reflected in the rules, that prices will be as volatile as the market.

The customer should pay the actual price for the month or other period in which the generation service was provided. The bids to supply default service should include prices that vary with the month (or with the hour for customers with meters that record hourly readings), based on each month's market price and/or price index, and the default service customer's price should vary accordingly, unless and until the customer requests the legislatively-required "payment options with rates that remain uniform for periods of up to six months". In other words, any such uniform rate payment option should be provided to an individual Default Service customer on request -- and not as a "default" feature of the service. If this payment option is essentially a budget billing arrangement, then customers should be clearly informed before they select such an option that they will owe the market (bid) price such that, while rates will remain uniform for 6 months, the customer will be at risk after the 6-month period to pay the market price if it turned out to be higher than the uniform rate (otherwise the customer would receive a rebate). If the "payment option" is really a fixed price for the six months, then the bidders may bid a higher price to take account of the forward price risk due to the uncertainty over future customer migration.

6. How often should default service be competitively procured?

Please see Section VI.D.

7. Are there examples from other states that would be useful to the Department in deciding how to determine the default service price?

Please see Section III and Appendix C.

APPENDIX C

Early Experience with Default Service Rights & Pricing in Other States

Although we are in the very early stages of electric restructuring, a few leading states have developed default service (referred to here in a general sense that encompasses the equivalent of Massachusetts Standard Offer and Default Services) and pricing approaches that provide insight into the creation of competitive electric markets. A leading indicator of competitive market activity is the number of customers that choose a competitive supplier, sometimes called the customer migration rate. Monitoring early market developments, including

customer migration rates, is crucial to adjusting existing market models and applying the experience to new markets.

Early evidence suggests that in those markets where default pricing is based on retail rather than wholesale rates, competitive markets are developing quickly. Whereas those markets that have low rates relative to wholesale prices are experiencing slow development. Likewise the default service award structure has been important to the development of early competitive markets. The approaches

and early results of four leading states are summarized below. Although each of these states are in the initial transition stage, their early experience reveal the importance of the level of default pricing and structure of default service.

California

One of the first states to restructure its electric market, California implemented a "poolco" approach that relies upon a centralized power exchange to determine the prices of default service customers. Regulated utilities purchase electricity from the power exchange and resell it at cost to customers. The prices customers pay are effectively a monthly average of the wholesale hourly price - an Index Rate. By charging customers a default price equal to a wholesale rather than retail market price, and by allowing the utility the right to provide default service, California default service policy strongly inhibits new market entry. The early experience reveals an efficient wholesale market and an anemic retail market. Figure 1 displays the customer migration rate after one year of competition: 1.3 percent.

Pennsylvania

Pennsylvania implemented a "shopping credit" model that uses a fixed schedule of default prices for up to 12 years. Currently, Pennsylvania utilities are granted default service status. Recognizing the value of the default provider asset, parties to the restructuring debate are planning to bid out default service for some or all customers at several of the Pennsylvania utilities. The Pennsylvania market has seen the most customer migration activity among open electric markets. This is due in large part to the size of the shopping credits (default service price) which vary by each Pennsylvania utility and each rate class. Pennsylvania regulators set a default price schedule for some utilities that currently exceeds the price of wholesale power. The significant "retail-wholesale spread" presents an opportunity for competitive suppliers to enter the market and Pennsylvania customers to save on their electric bills. An examination of the differences in customer migration among Pennsylvania utilities clearly illustrates the importance of the retail-wholesale spread. Two Pennsylvania utilities, PECO and Duquesne Light, have the highest retail-wholesale spread (roughly 1 cent per kWh). After four months of competition these two utilities had customer migration rates of approximately 13 percent. In contrast, Allegheny Power and PP&L have the smallest retail-wholesale spread (the default price and the wholesale price are about the same for some rate classes). Allegheny Power has a customer migration rate of about 2 percent and PP&L has a rate of about 3 percent. The chart above displays the customer migration rate four months after the Pennsylvania market opened - roughly 8 percent.

Georgia

The Georgia gas market provides a unique case in the restructured energy industry through the use of random assignment. The Atlanta Gas Light choice program requires all customers to either choose a competitive supplier or be assigned one. This is the same approach used in the long distance market in the mid-1980s. The assignment policy has created a strong incentive for suppliers to participate in the market, since suppliers will acquire a share of the non-migrating customer base for each customer they acquire directly. As a result of the assignment incentive and a significant retail-wholesale spread, the Georgia gas market has experienced the largest amount of customer migration of any restructured energy market. As displayed in Figure 3, roughly 57 percent of

customers choose a competitive gas marketer over an eight-month period from November 1998 to June 1999.

New Jersey Shopping Credits

The New Jersey Legislature passed The Electric Discount and Energy Competition Act (the "New Jersey Deregulation Act") on February 9, 1999 which opened the New Jersey retail market for competition effective no later than August 1, 1999. The legislation directed the New Jersey utilities to provide "shopping credits applicable to the bills of their retail customers who choose to purchase electric generation service from a duly licensed electric power supplier". (New Jersey Deregulation Act at § 4.)

The shopping credits were to further the Legislature's goals to:

- "(1) Lower the current high cost of energy, and improve the quality of choices of service, for all of this state's residential, business and institutional consumers;
- "(2) Place greater reliance on competitive markets, where such markets exist, to deliver energy services to consumers in greater variety and at lower cost than traditional, bundled public utility service"; and
- "(7) Provide diversity in the supply of electric power throughout the State".

(*Id.* at § 2.) Public Service Company of New Jersey, the state's largest utility, reached a restructuring agreement which the Board of Public Utilities (BPU) approved April 21, 1999. The Stipulation sets a shopping credit inclusive of an allowance for the cost of energy, capacity, transmission, ancillary services, losses, taxes and "retail adder". GPU Energy, another New Jersey utility, also reached a settlement, which is awaiting BPU approval, whereby the shopping credit would be inclusive of an allowance for the costs of energy, capacity, transmission, ancillary services, losses and taxes, plus an "incentive" or "retail adder" in order to enable customers to shop. Each utility's overall, system average shopping credit is 5.03 cents per kWh in 2000. The GPU Stipulation specifies a retail adder of 1.10 cents per kWh for the year 2000; the PSEG Stipulation does not specify the individual components.

Massachusetts

Massachusetts implemented a "standard offer" model, which is very

similar to Pennsylvania, in that the utility is granted default provider status and default prices are a fixed schedule over a period of years. Massachusetts has a "standard offer" for those customers who have not chosen a competitive supplier and a "default service" for new customers or those who have left competitive supplier service. Default prices, which are currently the same as the standard offer in Massachusetts, have been significantly below what a retail supplier can charge and are therefore quite different from Pennsylvania. The standard offer in Massachusetts has been at or below wholesale prices since the market opened in March 1998. As a result, few suppliers have entered the market and very few customers have chosen a competitive supplier. Those that have chosen are large. As Figure 3 shows, less than one percent of Massachusetts's customers has migrated as of May 1999.

Respectfully submitted,

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